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ECONOMIC LAW REFORM IN INDONESIA?*

by Paul H. Brietzke**

Studies of the opportunities for law reform under the new Indonesian Government are beginning to appear, even in English: the Vision 2000 Report (a translation is distributed separately), David Linnan's (1999), and that of Todung Mulya Lubis and Mas Achmad Santosa (1999), *for example*. Clearly, organizations like the IMF, the ADB, and the World Bank have issued almost-irresistible demands for economic law reforms, backed by the loans needed for economic and political survival. Reform was begun under the Habibie Government, and more reforms are being planned by the new Government. But after the international organizations' loans have been disbursed, will Indonesians want particular reforms badly enough to implement them effectively—even in the face of opposition from vested interests? The new Government has an historic opportunity to legitimate its policies, in ways denied its less democratic predecessors, but an explosion of party, regional, and citizen demands will likely make it difficult to adhere to a consistent reform plan. Can a consensus be built around further developmental reforms?

Reform dilemmas are summarized by Article 2 of the 1999 Competition Law, which requires that business activities be "based on economic democracy." What does this mean, when a political democracy is still evolving, and when the larger private and public economic institutions remain rigidly hierarchical: subordinates are fired or not promoted if they refuse to follow their superior's orders? How does such a democracy relate to, and inevitably get balanced against, the other goals in Articles 2-3 of this Law: efficiency, "equilibrium" between business and public interests, equality of opportunity among businesses of various scales, and "the people's welfare?" Such a balance implies that "economic democracy" refers to, and partly incorporates, Article 33 of the 1945 Constitution: "the national economy shall be organized as cooperative endeavor based on the family principle." Such a means of economic organization is the direct opposite of the "liberal" (*deregulasi*) economics on which Indonesian legal reform has been based—especially the Competition Law itself. (n. 1)

Resolving or at least accommodating this dilemma, of a liberal versus a *Rakyat* economy, is essential to the implementation of coherent reforms in Indonesia: see Linnan, 1999, 4-5. This is just another way of saying that politics will win out over economics, during a democratic reform process. Indonesians are increasingly making demands for the "liberal" rights known to be irrelevant in pre-democratic states: free speech, press, association, and participation. (Some Indonesians also demand self-determination for their ethnic or religious group.) Corresponding demands for "liberal" economic rights are more muted, however: broad and strong property rights—"That's *my* sandalwood tree (or ancestral forest)?"—freedom of contract, and freedom of enterprise. These are demands for an economic autonomy, for the right to succeed (*or fail*) free from interference by a paternalistic State or some political crony. (Refusal to accept the fact that autonomy can lead to failure is a major obstacle to implementing an effective bankruptcy law.) Some Indonesians seem content to wait for the State to do things they could (and, liberals would add, should) do for themselves, yet many anti-Statist attitudes are the natural outcome from years of authoritarian rule. *Deregulasi* has strong supporters as well as strong opponents, yet most Indonesians have not yet taken a position on economic reforms—other than to demand that politicians quickly cure the Crisis and promote development.

* A talk delivered to Department of Law and Legislation officials, February 21, 2000.

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How, if at all, can democratic support be created, for planned legal reforms that convert Indonesia's State (or crony) capitalism into a (liberal or social) market economy? The rapid growth in the number, strength, and independence of civil society organizations offers the most promising means to this end in Indonesia. The Asian crisis can be blamed (in part) on the absence of such organizations, which provide a check-and-balance running from society to government and the economy: Salim, 1999. Aided by independent and diverse media sources, the hope is that such NGOs will obtain information about, support, and closely monitor the pockets of reform that always exist within a system subject to many political distractions.

Such an NGO-led "democracy from below" would make law and the economy work for ordinary people (the *Rakyat*), by mobilizing previously-unorganized citizens through institutions which are accountable to them, rather than to some elite politician. Even in a highly-regulated place like Hong Kong, consumer organizations play important roles in promoting competition and trade liberalization: World Bank, 1998,9. We may hope that this new Indonesian politics will be structured (especially through constitutional changes) to avoid a "gridlock: a governmental paralysis which results from each organized interest group having a veto over policy changes.

Bolstering this civil society is a distinctively legal value that deserves a strong political constituency: the "rule of law" that is tied to an independent and competent judiciary and DPR, in an Indonesian *Rechtsstaat* In the second of six demands on a huge banner, hung on Jakarta's Welcoming Statue by the Student Forum in June 1999—*Tegakkan Supremasi Hukum* ("Go With...", 1999). This rule of law could displace socio-economic hierarchies and a (primarily Dutch) model of Guided Democracy, in the mediation of rights and reforms (Lindsey, 1999a, 8; Lubis, 1999, 171-74). A rule-of-law perspective also demonstrates that economic reforms are inseparable from the political ones: Democracy, human rights, and the rule of law are necessary to avoid a national disintegration, as well as to promote prosperity (Linnan, 1999, 25; Lubis and Santosa, 1999, 54—the economic crisis was caused by social injustice and a lack of public trust, a lack of good governance—and 68—"a self-retrospection...marks the final round of the economic development regime.")

IS AN ECONOMIC REFORM AGENDA POSSIBLE, WISE?

Pragmatic lawyers realize that all institutions fail simply because they are human. Just as divorces are a marriage failure, there are market failures, enterprise failures (bankruptcies), bureaucratic failures (over-regulation and corruption, for example), and political failures (East Timor and corruption, for example). Even constitutions are known to fail on occasion. The reform implications seem clear: design the best institutions you can, refrain from imposing unnecessary strains on them, give them a chance to develop, and then live with the (much-reduced) Institutional failures that will inevitably remain. The goal of planned institutional designs is to minimize the *net* of failures throughout the economy and society.

From this perspective, politics and the State are neither all bad nor all good. Rather, they will fail about as often as other institutions, and they are thus the problem and the solution (for human rights or development, for example) in roughly equal measures. The policy goal is to suppress the governmental mischief wherever possible, and to advance the governmental remedy wherever necessary. It is fortunate that a *private* process of economic reform is also going on, a process which can be strengthened through legal reforms. While marketplace exchanges involve contracts, economic actors can also use contracts to create market *surrogates* (market substitutes like companies or political parties) to achieve their aims—and reduce risks and transaction costs in the process.

Such private reform is much more difficult in Indonesia than in many other countries, because of a basic characteristic of the legal system here: it *strongly tends to over-determine that which it under-categorizes*. This is a mouthful, I know, so I will try to explain what I mean. A traditional civil law system like Indonesia's tries to create a highly prized coherence and consistency (values put at risk by previous, ad hoc reforms—*supra*) by exhaustively enumerating institutional types and functions—i.e., by fully stipulating all statuses—in advance. Due to a failure of legal changes to keep pace with economic changes, the categories of statuses permitted by the law are insufficiently rich to facilitate the many niche activities that characterize a complex modern economy. In other words, Indonesian law under-categorizes economic activity and, apparently to regulate activities in detail and to conserve coherence and consistency, Indonesian law permits relatively little private law reform (*supra*): the “customizing” of institutions and transactions by the parties, to achieve their aims through contractual means that reduce risks and transaction costs.

Arguably, Indonesian law thus over-determines what it under-categorizes. Absent legal reforms, Douglas North's (quoted by Trebilcock, 1997, 45) “institutional sclerosis” will continue to plague Indonesia—and many other countries as well. Useful reforms would eliminate many (*inefficient*, unnecessary, and corruption-provoking) business licensing requirements, permit cheap limited-liability partnerships and closely-held corporations, and allow non-governmental, perhaps non-profit, organizations to conduct business in their own names.

To sum up the legal and economic points I have been making, the goal of planned reforms is to *design and redesign institutions to embody clear goals, a good 'fit' with other institutions, and the best incentives and organizations that selectively adapt and adopt existing cultures*. Complex analyses based on organization theory are presented elsewhere—Brietzke, 1999—and are thus not repeated here, but brief mention will be made of cultural issues that are presumably of more interest to the assembled colleagues. Such issues used to be treated simply, as a need to respond to “Asian values”, but the public increasingly realizes how these values are manipulated in self-serving ways by their pre-democratic advocates. Some cultural changes are desirable and even essential to an institutional and general development in Indonesia, but there are also many ways of designing institutions, and re-designing those responding to archaic forms of colonial (Dutch) and Javanese culture, so as to respond to democratically-expressed Indonesian needs and desires.

The often-agonizing ferment Indonesians are experiencing—economic recession, unrest and violence, marketization, democratization—can have two contradictory effects. It makes people seek renewal or a sense of direction in some traditional (especially religious) way of doing things, while also exposing shortcomings in these ways and encouraging certain kinds of cultural experimentation. Policymakers can seek to bend such contradictions in developmental directions, and I argue (Brietzke, 1999; Brietzke and Timberg, 1999) that the best place to start is the bureaucracy—by turning repressive colonial institutions into a *civil service*. Like other institutional actors, bureaucrats resist change. But they are also potent change-agents, once their culture is transformed through reformed incentives, organizations and ideologies, and an improved education and training. Predictable bureaucratic enforcement is required for a stable institutional environment. Predictability requires marked reductions in corruption, effective incentives (adequate pay, for example), appropriate institutions, modernizing cultures among the implementers, and adequate training and investigative and managerial resources: Lindsey, 1999a, 8; Ratliff and Buscaglia, 1997, 314.

THE PLAN, BRIEFLY

A sketch of some likely reforms (admittedly, compiled by a foreigner) is offered here, to suggest the magnitude and scope of the political problems the new Government will face. This plan is divided into five parts. I, II, and III are the most important and time- and resource-consuming reforms. Ideally, they would begin immediately, since the success of other reforms depends on them. IV describes important, sector-by-sector reforms that can arguably be pursued in almost any order, perhaps in response to political priorities, provided the consistency of the overall plan

is kept in mind. V describes those reforms partly beyond Indonesians' control, with effects flowing indirectly from the reform efforts described in I—IN.

I. *Judicial Reforms*: an independent judiciary is dangerous, unless it is made more transparent and accountable through an effective judicial commission, etc. Reasoned judicial opinions must be published and widely available, to highlight areas for further reform, to identify the levels of competence among particular judges, and to reduce the corruption that flows from decisions taken in secret. Other, neutral strategies for distinguishing good and bad judges must be applied, and management, personnel, and salaries must be improved. Many believe this "package" to be the most important law reform step. (Linnan, 1999, 10, 17; Vision 2000.) A German-style Constitutional Court is also needed, but perhaps only after the Constitution is amended and thus capable of withstanding a searching scrutiny.

II. *Reforms in administrative law and agencies*. Indonesia has little law that applies beyond a specific agency or a specific regulatory task. Such a transparent and general public law should be developed so as to promote efficiency and an accountability to the public, along with a deregulation and a selective re-regulation. The agency structure of the Indonesian bureaucracy should be modernized, to account for Government's new, democratic roles. This massive task should not be undertaken in the absence of sustained commitment from the new Government. Changing the law will mean a loss of control, and of some of the other benefits of office, and bureaucratic competitions to maintain control and benefits must be neutralized: Linnan, 1999, 7.

III. *Corruption* flourishes in the absence of judicial and administrative transparency and accountability. Reforms in I and II will thus reduce corruption: e.g., bribery is sometimes "efficient"—a cost-effective way to defeat regulations and judicial procedures so inefficient that they should be eliminated or replaced. But more is needed. While a good beginning has been made, there is much more to be done— especially with regard to implementation of reforms, in the face of opposition from vested interests.

IV. *Sector-by-sector reforms*: see note 2.

A. Barriers to entry into Indonesian *markets*, many of which are still fragile, thin or fragmented during the transition from a command economy, are best reduced, and markets strengthened and made more dynamic in the process, through a restrained *implementation* of the new Competition Law by the Commission. Especially important is the removal of regulatory barriers, such as those granting special privileges to cooperatives (*infra*) and other middlemen. Barriers to exit from markets can be reduced through an effective bankruptcy law (*supra*), and a useful Corporate Reorganization Draft Law is being prepared.

B. To strengthen markets and increase efficiency, redesign archaic contracts and property laws, and remove administrative law restraints on using these private laws see over-determination, *supra*. Actors could then engage in private law reform by customizing their transactions and creating market surrogates (*supra*).

C. Indonesia's *Companies Law* is cumbersome, unrealistic (full of legal fictions, for example), and otherwise inefficient. Models from other countries suggest likely reforms: increased duties of disclosure, to provide the information that promotes transparency, accountability, and sensible regulation; "international standard" auditing requirements, as essential to this disclosure; expanded fiduciary duties, owed by company managers to creditors, shareholders, employees, and perhaps consumers and citizens injured by pollution; informal but effective means of enforcing these duties and, as a last resort, the *locus standi* needed to enforce them in a court; and a wider use of the "business judgment rule", linked to permitting companies broadly to engage in all lawful activities. These reforms would lead to a more transparent and dynamic Stock Exchange, but separate reforms of the Capital Market Law should also be considered. A corporate governance (extra-legal) code of conduct could be devised and enforced informally, and other laws should also be revised—in an "Enterprise law

package”: foreign and domestic investment laws, and the laws discussed *infra* at E, F, and G, for example. Increased regulatory burdens would admittedly result from these steps, but almost all existing regulations could be replaced during administrative reforms (II, *supra*)—in a net deregulation.

D. *Intermediaries* communicate valuable information cheaply, and spread and diversify risks throughout the economy. They are the enterprises that are particularly underdeveloped in countries like Indonesia: banks, less formal and smaller-scale lenders like credit unions, insurance companies, equity brokers on the Stock and Commodities Exchanges, and even coops and the creative use of contracts (*supra*) that is currently truncated in Indonesia: see over-determination, *supra*. Details on reforms cannot even be summarized here, but they revolve around the relatively new economics of risk management, parallel reforms in administrative law (II, *supra*), and a more effective Fiduciary Transfer Law.

E. *State-owned enterprises* (SOEs) should be privatized where this will contribute to both Government revenues and an increased competition. Other SOEs should be effectively reorganized, and many could be run under performance-based contracts by managers from the private sector. These SOEs should cease being the prime beneficiaries of Governmental regulations (II, *supra*).

F. A formalization and deregulation of *informal proprietorships and small companies* (informal businesses of larger than cottage size) is probably the quickest Crisis ‘fix’, the easiest enhancement of an economic pluralism, a major control over corruption because it eliminates many bribe-opportunities (II. & III., *supra*), and a partial response to the demands of Indonesian populists. But populist policies of State allocation of funds for proprietorships would increase the inefficiency of markets and proprietorships alike. A better and cheaper regulation of the less formal end of the intermediaries sub-sector (IV D, *supra*) is a better solution.

G. *Cooperatives* have important potential roles to play in a pluralistic economy, roles which are impossible so long as coops are corrupted to serve elite purposes. In Brietzke & Timberg, 1999, I detail limited state roles and a legal accountability of managers to coop members, rather than the special privileges and subsidies that create inefficiencies without benefiting coop members in the long run,

H. *Adat* (customary) institutions in the subsistence sector, all but ignored by State law (the Agrarian law of 1960, for example) and by banks, have important roles to play in development. Legal reforms must obviously be sensitive to local needs and cultures. An individualization of *adat* land tenures and institutions, sponsored by the World Bank, could be complemented by legal adoption (and some adaptation) of communal tenures and institutions. This process, and a non-regulatory Government assistance, are sketched in Brietzke & Timberg, 1999.

I. The restrained but effective *implementation* of the new Consumer Protection and Competition Laws would increase consumer welfare (surely an important part of “the people’s welfare”), a popular way of gaining votes in a democracy. Effective *implementation* of existing environmental laws would reduce the involuntary consumption of pollution that injures all Indonesians. Labor law reforms should set the criteria for recognition of trade unions, criteria that impose responsibilities as well as rights, to increase the stability of business expectations and to foster unions as valued members of the new civil society (*supra*).

V. International efforts to regulate *multinational corporations* (MNCs) have made little progress, and Indonesian efforts to “tame” them would only reduce the inflow of capital and technology—while the MNCs keep their secrets and produce relatively more in other, less restrictive countries. Similarly, there is little progress in international-level exchanges of information about, and a modest regulation of, competition and the debt and equity transfers that can jump in and out of Indonesia at the click of a computer mouse. The best Indonesians can do is effectively to implement reforms like those in I—IV. to convince foreigners that a more

transparent and congenial economic climate is worth supporting. But the new Government does have important roles to play in trade promotion and finance. While a start has been made, the relevant (WTO, etc.) reforms must be *implemented* effectively.

Even if a conscious legal neutrality is pursued (*supra*), there will be failures in economic institutions (*supra*) that Government can and should do little to fix. The protectionism of the past has failed and, in a democracy, economic actors are free (autonomous--*supra*). I hope that Indonesians will get the economic (and of course political) reforms they have deserved for so long.

The Chinese have a curse, rather than a blessing: "May you live in interesting times." Times certainly are interesting in Indonesia, and I envy the opportunity you will have to assist in legal reforms--and thus pursue the sophisticated nationalism of contributing to Indonesian development. (I cannot have a similar effect in my own country.)

Whether the elements in my plan are the best ones for Indonesia is for you to judge. I hope you will now tell me where I have gone wrong, so that I can work for your Ministry better. Thank you for listening so patiently.

End Notes

1. Linnan, 1999, 13. See Lubis & Santosa, 1999, 61-63: Art. 33 embodies a Pancasila economy, neither free market nor etatist, experimental but disrupted by KKN, a "commandeer economy" where interference has generated fragility.

2. Like many other economies, Indonesia's can be described in terms of nine sectors, each characterized by the distinctive legal regime which describes the sector's institutions: markets (property and contracts law, competition policy, etc.); foreign-dominated (especially multinational) corporations (which are often immune to regulation under domestic law), some with politicians', bureaucrats' or Government participation; domestic companies, some with foreign investors or politicians', bureaucrats' or Government participation; Government-controlled and —regulated enterprises; cooperatives and other nonprofit organizations; individual proprietorships of larger than cottage size; (near-) subsistence farming, fishing, forestry, and handicrafts/cottage industry; the international sector of trade and aid, debt, and equity inflows; and labor and consumers. Bnetzke and Timberg, 1999. This focus on institutions and an institutional economics echoes a growing consensus, in Indonesia. and among development theorists, that institutional capital is more important than the other forms of capital, viewed through a matrix of democratic-bureaucratic-legal system development: Trebilcock, 1997, 17-18, 40. An institution involves formalized actors and repeated transactions that transform inputs (resources) into some valued output: democracy or (other) marketplace exchanges, for example. An institution has a history, a cultural context, and an interchangeable wealth and power. This power is used to resist changes, to change other institutions and environments, and to otherwise shape and restrict the choices of other individuals and institutions, For example, democracy is stabilized through institutions that decrease the stability of political cartels, and reduce the transaction costs of resistance to tyranny. Cooter, 1997, 13 5-36; Goodin, 1998, 7, 12; Trebilcock, 1997, 45. Good institutions are at least as important as good laws and personnel, given the institutional context of underdevelopment and unfavorable repetitions of behavior: Seidman & Seidman, 1997, 6-7.

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